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Comment Letter on the European Commission's consultative paper, "Statutory Auditors' Independence in the EU: A Set of Fundamental Principles."

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Independence Standards Board

ISB

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By E-Mail and Regular Mail

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European Commission
Internal Market DG
Financial Services – Financial Reporting
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Dear Mr. Niehues:

We are pleased to have the opportunity to comment on the European Commission's consultative paper, "*Statutory Auditors' Independence in the EU: A Set of Fundamental Principles*." Our comments reflect the views of the Independence Standards Board's staff, and not necessarily those of the Board.

Harmonization

It is gratifying to see the current focus on auditor independence throughout the world, and the degree of similarity in approach taken by the Commission, the Federation des Experts Comptables Europeens, the International Federation of Accountants, and the ISB. We believe a principles-based threats and safeguards approach, that considers the expectations of investors and other stakeholders, is the most effective way to develop consistent and coherent standards that protect the public interest. We endorse the Commission's test of independence; that is, whether "a reasonable and informed third party, knowing all the relevant facts and circumstances about a particular audit engagement, will conclude that the statutory auditor...is exercising objective and impartial judgment on all issues brought to his attention (A)."

We are also pleased to see the Commission's proposed adoption of requirements similar to those in ISB Standard No. 1, *Independence*

Discussions with Audit Committees, and ISB Standard No. 3, *Employment with Audit Clients*. We agree with the Commission's conclusion that independence can never be absolute – that the auditor cannot be completely free from all economic, financial, and other relationships that could appear to entail dependence of any kind. Finally, we support, in most cases, an approach of limiting restrictions and prohibitions to those within the firm that are "in a position to influence the outcome of the audit."

Definition of Independence

We believe that a clearer definition of auditor independence would improve the Commission's framework. The document differentiates between independence in mind and independence in appearance, but also describes independence as a means of demonstrating objectivity and professional integrity. We understand the view that independence could be defined as compliance with a set of restrictions on relationships with audit clients as a means of demonstrating objectivity, but then we are not sure how this relates to the other components in the described model.

The basic test of independence described in the first sentence of the document (A) states that the auditor should have "neither mutual nor conflicting interests with the audit client." We do not believe that this clause adds clarity to the test, as the auditor, for example, may have a mutual interest with the client in reliable financial reporting, and a conflicting interest in negotiating audit fees.

The document uses the term "impair" or "impairment" when describing circumstances that would cause the auditor to be considered not independent. When drafting the ISB's conceptual framework, we found that many people understood the term "impairment" to describe circumstances that "affected" independence, rather than those that rose to the level of causing unacceptable independence risk. In other words, the term implied that perfect independence was attainable, and that any threats affecting the auditor's independence were unacceptable. We found that the term "compromise" caused less confusion, in that people generally understood that we were describing circumstances that crossed a threshold (acceptable risk vs. unacceptable risk) in affecting the auditor's independence.

Evaluating the Acceptability of Independence Risk

The Commission's framework is consistent with the ISB's in calling for an analysis of the significance of threats to independence, the effectiveness of potential safeguards, and the acceptability of independence risk. We suggest that the discussion regarding independence risk could be enhanced, however. The term is not defined, and guidance is not provided on assessing the acceptability of independence risk. Most importantly, the level of acceptable risk might vary based on cost / benefit considerations. That is, the cost of additional safeguards (e.g., unintended consequences of regulations that ultimately decrease the quality of financial reporting and user reliance on audited financial statements) may exceed the benefit of reduced independence risk. The framework, however, does not explicitly provide for cost / benefit analysis in setting standards.

Cost / benefit analysis may be particularly helpful in articulating why safeguards should be, in some cases, less restrictive when auditing non-public-interest clients. For example, the document states that self-review concerns arising from the provision of bookkeeping services are higher for public interest clients, and therefore the auditor should not perform these services, regardless of the level of assistance requested (B.7.21). The rationale for more stringent requirements on public interest clients (and less restrictive standards on other audits) is not clearly articulated, beyond the potentially larger group of stakeholders associated with public interest clients who may have negative perceptions of these services. We believe such distinctions in the application of safeguards may be appropriate in certain circumstances, when costs and benefits are considered, but that this analysis and conclusion should be clearly articulated in the standards.

<u>Threat Analysis</u>

A more robust analysis of threats and safeguards as they apply to specific situations would enhance the document. The threats are generally listed in the black letter sections of the requirements (i.e., self –interest, advocacy, etc.). Mandatory or suggested safeguards, including prohibitions and restrictions, follow. Sometimes, however, the nature or origin of the threat is unclear. For example, some might wonder why litigation poses a self-interest threat to the auditor's independence. The effect of the suggested safeguard may also need elaboration. Even an auditor well versed in independence matters may wonder why discussion with the audit committee might adequately mitigate the threat posed by litigation (B.9).

Guidance on how the auditor should consider appearances is sketchy. In some cases, threats to the appearance of independence are discussed in a way that gives the impression that the relationship

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in question does not pose an *actual* threat to independence. For example, dependency on fees from a client, in our view, poses a real threat to the auditor's independence, yet much of the discussion in this section focuses on the appearance of dependency (B.8.2).

Standards should not permit an individual professional or the firm to act as auditor if threats to independence are not adequately mitigated. In that connection, a strengthened threat and safeguard analysis when applying the principles to specific relationships might lead to changes in the requirements. For example, the threats posed by significant financial interests in the audit client held by an engagement team member are not mitigated when the professional receives the financial interest by gift or inheritance. The requirement to dispose of the financial interest at the earliest practicable date (which may not be in the near future), and to consider safeguards such as review of the individual's work or exclusion of the professional from substantive decision making, does not seem to adequately address the threats, including those related to appearance (B.1.(2)).

Similarly, a "significance test" in prohibiting certain business relationships between the audit client and those who could influence the outcome of the audit does not adequately address appearance threats, and fails a cost – benefit test. Why allow the engagement partner to loan money to his or her audit client, or to guarantee the client's debt, however insignificant (B.2.)?

Finally, the threats raised by audit firm professionals assuming employment positions at their audit clients would seem to apply to other engagement team members, particularly more senior members, as well as to the engagement partner. Why shouldn't the firm review the relationships of these former firm professionals with remaining engagement team members? Similarly, the threats posed by unsettled financial interests might apply to former firm professionals in important positions at the client regardless of whether they were previously involved in the audit, or part of the chain of command.

The document states that a threat can be considered significant "if, considering all of its quantitative and qualitative aspects, it increases the level of independence risk to an unacceptable high level" (A.3.). We believe that this sentence is confusing, as it implies that:

- threats may be analyzed and dismissed individually, as long as they do not raise independence risk to an unacceptably high level on a stand-alone basis; and

- independence risk should be assessed before the effect of safeguards.

Responsibility for Compliance

The framework sometimes places too much responsibility on the engagement partner for determining the application of and compliance with the independence rules (A.2.). In view of the size and structure of large firms today, the framework should acknowledge that individual engagement partners are unable to ensure compliance with the independence rules by the firm and other firms within a network, and by firm employees able to influence the outcome of the audit including those in the chain of command. This responsibility should rest, as the framework later states, with the firm, which has the ability to determine to whom restrictions should apply, and to put quality controls in place to promote and monitor compliance. While we understand that the appointed statutory auditor, who may be an individual, might have legal responsibility in some jurisdictions for compliance, we believe this assignment of responsibility is unrealistic in a framework that extends restrictions beyond the appointed statutory auditor to a potentially large group of individuals in the firm, to the firm itself, and to other individuals and firms within a network.

Limiting Restrictions to Those Able to Influence the Outcome of the Audit

We support, in most cases, limiting restrictions to the firm and to those professionals with the ability to influence the outcome of the audit. The requirements sometimes carry this notion too far, however, without obvious benefit. Recognizing that to some extent the activities and relationships of firm professionals are attributed to the firm, we believe standards should prohibit all firm professionals from having certain relationships with firm audit clients. For example, we do not believe that firm professionals should serve as employees or board members of audit clients, or act as underwriters for an audit client's securities. Similarly, none of the firm's professionals should be permitted to maintain the accounting records of the client.

In addition, while we agree that many of the financial interest prohibitions should be limited to those able to influence the outcome of the audit, some limitations should apply to other firm professionals. We believe, for example, that it would be inappropriate for a firm to audit a company over which one or more of its professionals can exercise control or significant influence.

Family and Other Personal Relationships

The requirements apply employment and financial restrictions to close family members of the engagement team and the chain of command (B.6). We would distinguish between immediate and other close family members in applying restrictions (i.e., applying more stringent restrictions to immediate family members).

In addition, because restrictions are applied evenly to a larger group of relatives, clarification is needed on the auditor's responsibility to inquire about the investment holdings of, for example, parents and siblings. If the auditor does not have this investigative responsibility, then the requirements should clarify these limits and state that the auditor must only act on those relationships of which he or she becomes aware.

We believe that the auditor should be expected to have knowledge of the investments of those in his or her household (immediate family members), but not the investments of other close family members. Furthermore, investments of other close family members can only compromise the auditor's independence if they are known and are material to both the auditor and the close family member.

Internal Audit Services

The requirements call for review of internal audit work by a partner uninvolved in the statutory audit or the internal audit engagement, presumably when the audit team will rely on the internal audit work to change the nature, timing, or extent of their own procedures (B.7.2.4(2)(b)). We do not believe this is necessary and would impose additional costs without benefit.

The auditor may rely on the internal auditor's work (control and substantive testing) after evaluating the internal auditor's competence and objectivity, and testing the effectiveness of the internal auditor's work. Whether to rely on the internal auditor's work, or to perform such work himself or herself, is the auditor's prerogative and is a question of efficiency. Since the auditor has this choice – to rely on the work of the internal auditor, after performing the required evaluations, or to have an audit team member perform the work, which is subject to standard review procedures - why are extra steps necessary when audit firm professionals perform internal audit work?

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In addition, we question whether the term "the internal audit function" in B.7.2.4(2)(a)(i) should be replaced with "internal controls."

Fees

Fee dependency is a complex topic. In one sense it is easier to assess and measure than other threats to independence, such as familiarity – there are hard numbers available to assist in assessing the significance of the client to the firm. On the other hand, the significance of a client to an engagement partner's compensation and career may be harder to measure; sometimes the loss of an average-sized client of the firm may have significant adverse consequences to a firm professional. The profitability of services provided, the reputational value of the client association, and whether the engagement is a recurring one must also be factored into the assessment.

Recognizing the difficulty of the subject, we still find the guidance provided on fee dependency confusing and difficult to apply (B.8.2). The black letter guidance states that services provided should not be allowed to create a financial dependency on the client, in fact or appearance. Later, we are told to have another audit partner uninvolved in the audit or in the provision of non-audit services review all work performed by the firm for the client if there is some level of dependency.

We do not understand why "independence may be particularly compromised" by fees for non-audit services. While additional focus on non-audit engagements may be appropriate when fee dependency is in question, because of their recurring nature, audit fees may pose a greater threat to the auditor's independence than fees received on a one-off non-audit engagement.

A test based on fees in relation to revenues *in each of the last 5 years* seems liberal. Isn't there a question of dependency if fees from a client are, for example, 25% of the firm's revenues in each of the last 2 years?

Finally, in the black letter guidance on overdue fees, we are told that auditors should not accept engagements where overdue fees could be considered a loan. The commentary, however, suggests that disclosure to relevant third parties might adequately mitigate this threat (B.8.3).

Litigation

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The second paragraph of the black letter guidance (B.9.(2)) states that the auditor should "cease to act" as soon as litigation becomes evident, which implies resignation from the engagement. Resignation, however, is only one of the remedies provided in the next sentence.

<u>Other Comments</u>

We are not sure that the requirements provide enough guidance on the application of independence rules to entities affiliated with the firm in alternative practice structures.

The requirements prohibit the provision of audit services to non-auditor owners holding more than 5% of firm voting rights (B.4.3.1(2)). We suggest that the prohibition also be operative if the stock is held by the entity's officers, directors, or significant shareholders.

In discussing non-audit services, the auditor is cautioned to avoid making decisions on behalf of the client. The auditor is told to provide management with the opportunity to decide between reasonable alternatives, or to document the situation if legal or regulatory provisions allow only one course of action (B.7.1). We suggest that there may be other situations where alternatives are not limited by legal or regulatory constraints, yet only one feasible alternative exists.

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We would be pleased to discuss these comments with you. Best wishes for success in this important and worthwhile project.

Sincerely,

Arthur Siegel
Executive Director